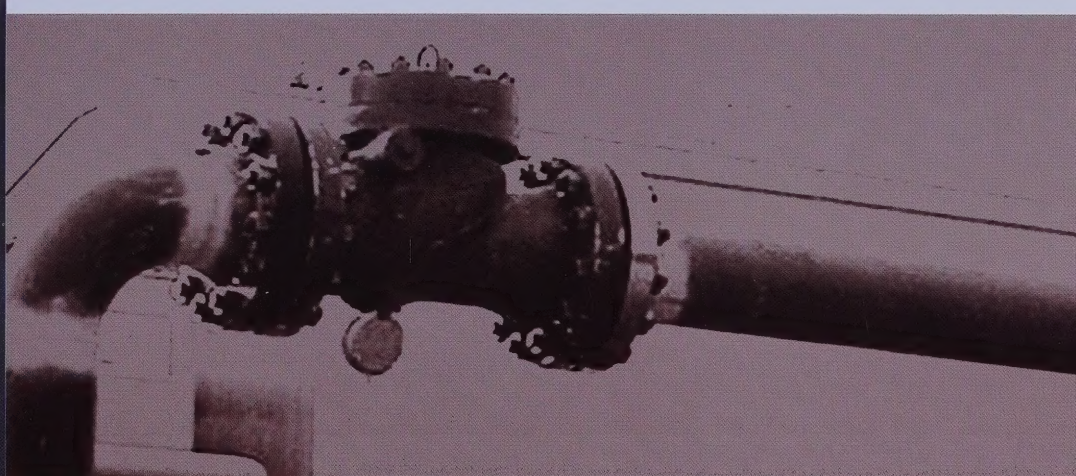
yangarra resources inc.

annual report 2003



yangarra resources inc.

exploration
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gas

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annual report 2003

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Corporate Profile

Yangarra Resources Inc. is a junior oil and gas company engaged in the exploration, development and production of petroleum and natural gas reserves in Alberta.

Yangarra trades on the TSX Venture Exchange under the symbol "AYX"

The Annual General Meeting of Shareholders of Yangarra Resources Inc. will be held on Tuesday, April 27th, 2004 at 3:00 p.m. at Suite 1530, 715 -5 Avenue S.W., Calgary, Alberta.

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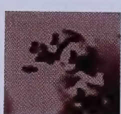

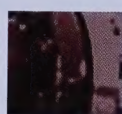

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President's Message

To Our Shareholders

2003 has turned out to be an incredible year for Yangarra Resources Inc. In early 2003, the stock was consolidated on a 4 for 1 basis. The name of the company was changed from Ayrex Resources Ltd. to Yangarra Resources Inc., which reflected the fresh start we have experienced. With the sale of Glacier Ridge Resources Ltd. (a private company which sold to High Point Resources Ltd. July 15, 2003 for $48.2 million dollars including working capital deficiency, debt and a 2004 bonus), the management team was able to concentrate on Yangarra Resources Inc.

During the latter half of 2003, Yangarra raised a total of $8.9 million, and ended the year with 18.1 million shares (basic) outstanding, $2.7 million in the bank and an unused $2.5 million line of credit at The National Bank.

With the Management Team focused, we moved quickly on the exploration front. An Area of Mutual Interest (AMI) was signed with Birchill Energy Ltd. on $1^{1/2}$ townships in the Ferrier area (extended to 2.0 townships in 2004). Two wells were drilled by the end of 2003 with four follow-up wells in Q1 of 2004. A 10.0 million cubic feet/day gas plant is under construction and will be on stream by May 14, 2004. Initial rates from five of the six wells indicate that the plant will be full, with Yangarra at a 50% working interest.

After completion of the Ferrier deal, the Company pressed onward to sign a Farm In with Entrada Energy Inc. (a non-arms length private company with a common president and directors) on a 130 section property south of Medicine Hat. This property had 20 wells drilled to the Second White Specs covering the land spread and required capital to begin production. Yangarra initially spent $4.6 million to earn a 50% working interest. 19 wells were drilled and a gas plant capable of 4.0 million cubic feet/day was built and on stream by December 21, 2003. Future plans include a plant expansion to accomodate 30 new wells in Q3/04.

Yangarra negotiated a joint venture with Goose River Resources Ltd. to participate in a 7 section Colony gas play in Paradise (50% working interest) with the first well drilled in Q4/03 and a follow-up well drilled in Q1/04. Yangarra also participated in a 9 section deal with Goose River Resources Ltd. in Smoky Heights (33 1/3 % working interest) chasing a high impact Kiskatinaw opportunity in Q1/04. This well was not cased, but proves our geological and geophysical model.

The market place has been very supportive of Yangarra's stock price with an initial price of 28¢ / share and ending the year at $1.20 / share. Subsequent to year end, another financing of $2.5 million shares at $1.45 was announced and closed with proceeds ensuring that Yangarra continues to have a strong balance sheet. Yangarra exited 2003 at 140 boe/day (6-1) and is forecasting production rates of 1,000 boe/day by June 30th with an exit volume at December 31st of 1,500 boe/day.

cont.. pg 03

President's Message, *cont.*.

Yangarra is looking forward to a prosperous 2004 with a strong balance sheet, great properties, and strong commodity prices.

On behalf of management and the board of directors, I would like to thank the shareholders for your continued support.

James G. Evaskevich
President & Chief Executive Officer

Ferrier 2-4 Compressor inlet

Medicine Hat

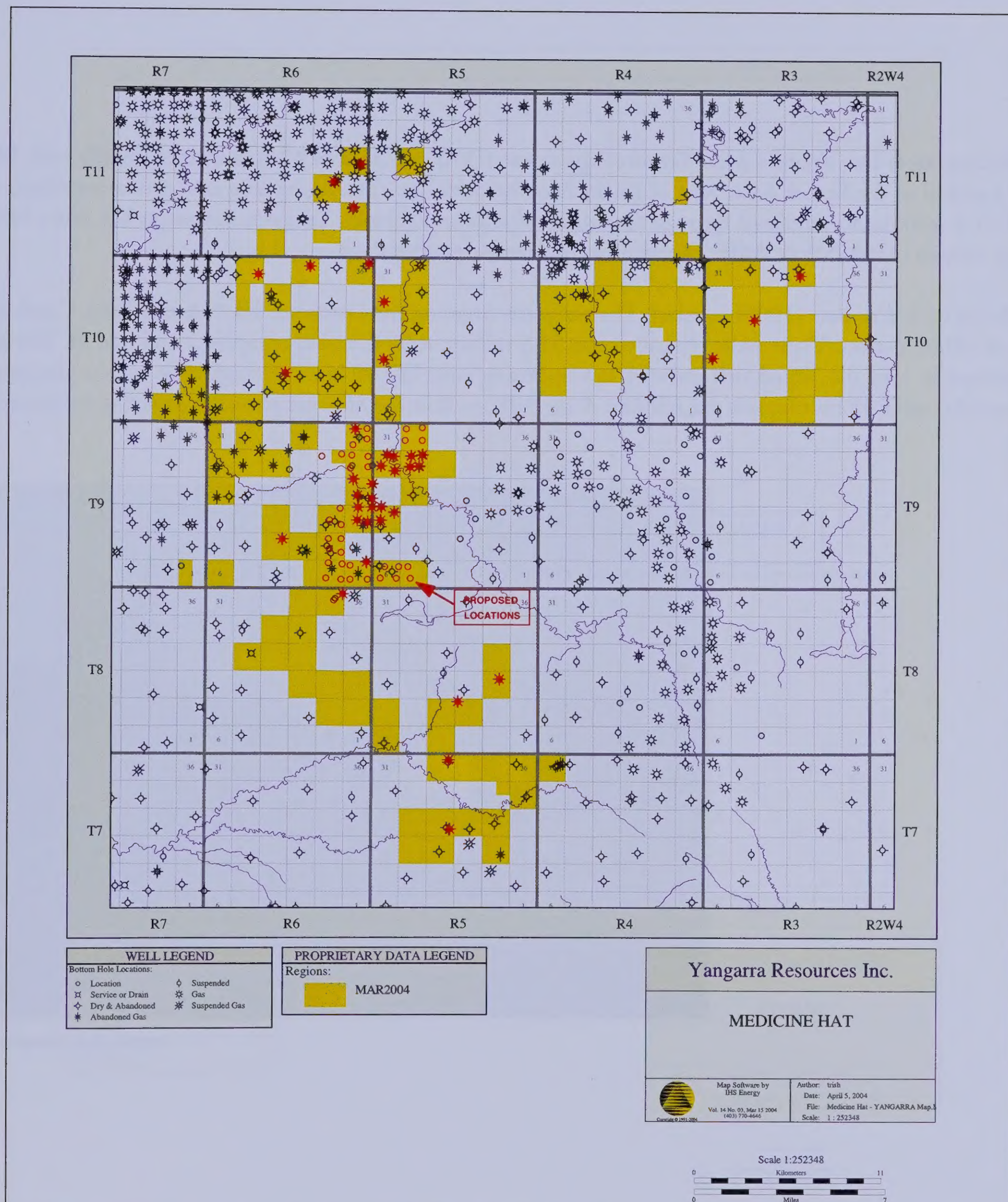
Yangarra Resources has a 50% working interest in 130 sections of land.

To date the company has drilled 40 wells in the Medicine Hat area. A 4.0 million cubic feet per day gas plant and gathering system was completed and on stream December 21, 2003. 19 wells are currently tied in with 14 operating at this point. Debottlenecking has been required on the gathering system and this process is ongoing. Current gross production is 1.8 million cubic feet per day. As water rates are initially quite high, a water transfer system and injection well are key to low operating costs. The water system should be operational by mid March.

Optimization of the current wells have begun. The five shut-in wells and two of the new shallow wells will be operational by the end of March.

Phase II planning is currently underway and additional lands are being acquired in the area.

Medicine Hat Gas Plant @ 5-25-9-6W4



Medicine Hat

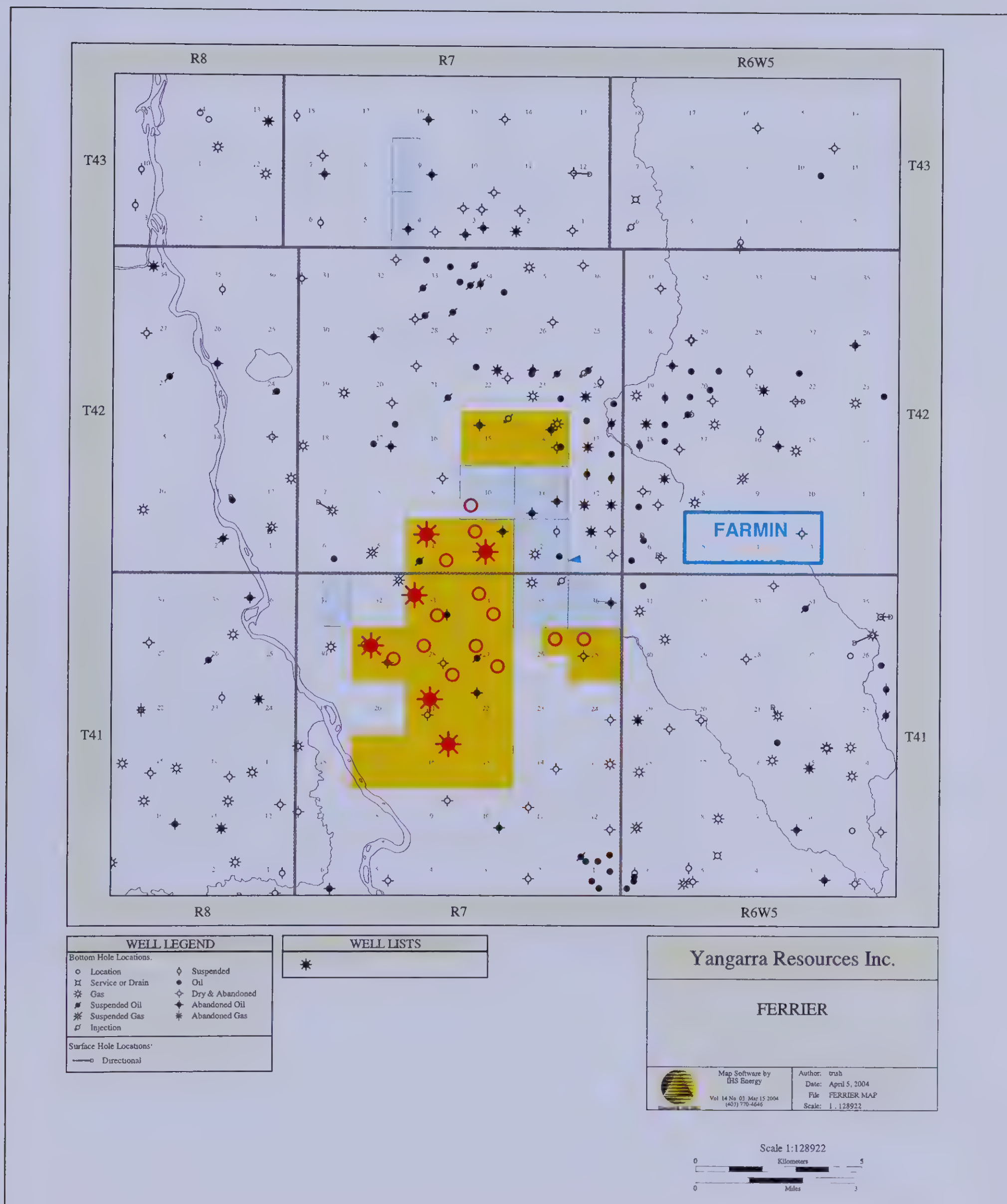
yangarra resources inc.

Ferrier

Yangarra Resources Inc. signed a Joint Venture Agreement (JVA) and Area of Mutual Interest (AMI) with Birchill Energy Limited in the Ferrier Area, west of Rocky Mountain House. The Agreement covers two townships with a total of 21.5 sections accumulated through Crown Land sales and Farmin. Yangarra Resources Inc. has a 50% working interest in the JVA & AMI. The area has multi-zone potential

Six wells are drilled to date (100% success). The wells are targeting the Ostracod, Ellerslie and Rock Creek zones at depths of +2600 meters. These wells typically costs $1.5 million drilled, cased, completed and tied in. The area is characterized by long life, liquid rich gas with low operating costs ($3.00 boe). Average wells for the area produce 1-3 mmcf/day with 45 bbls liquids per million. A 10 million cubic feet/day gas plant scheduled to be on stream in Q2/04.

Ferrier 2-4 Compressor



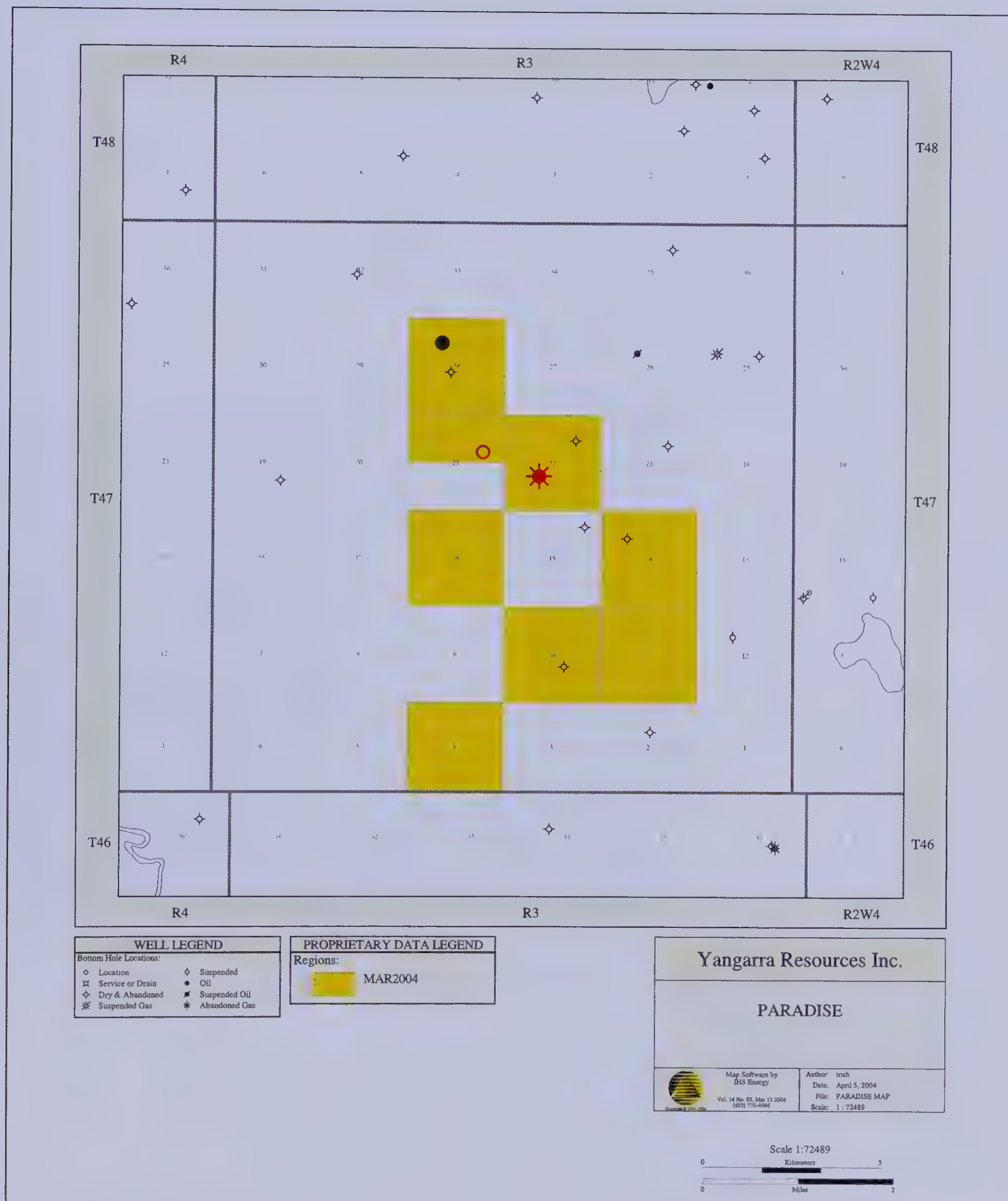
Ferrier Project

Paradise

Yangarra Resources Inc. signed a Joint Venture Agreement (JVA) and one township area of Mutual Interest (AMI) with Goose River Resources Ltd. in November 2003. There have been $7^{1/2}$ sections acquired to date (50% working interest for Yangarra Resources Inc.) in the AMI with efforts underway to acquire more in the near future.

One well has been drilled to date. Test results from the first well show low productivity. A second well is drilled, and cased, and soon as a rig is procured, will be completed. An agreement has been reached with a producer in the area to be partners on a new gas plant. The decision to go ahead will be contingent on the success of the second well.

Ferrier 2-4 Construction



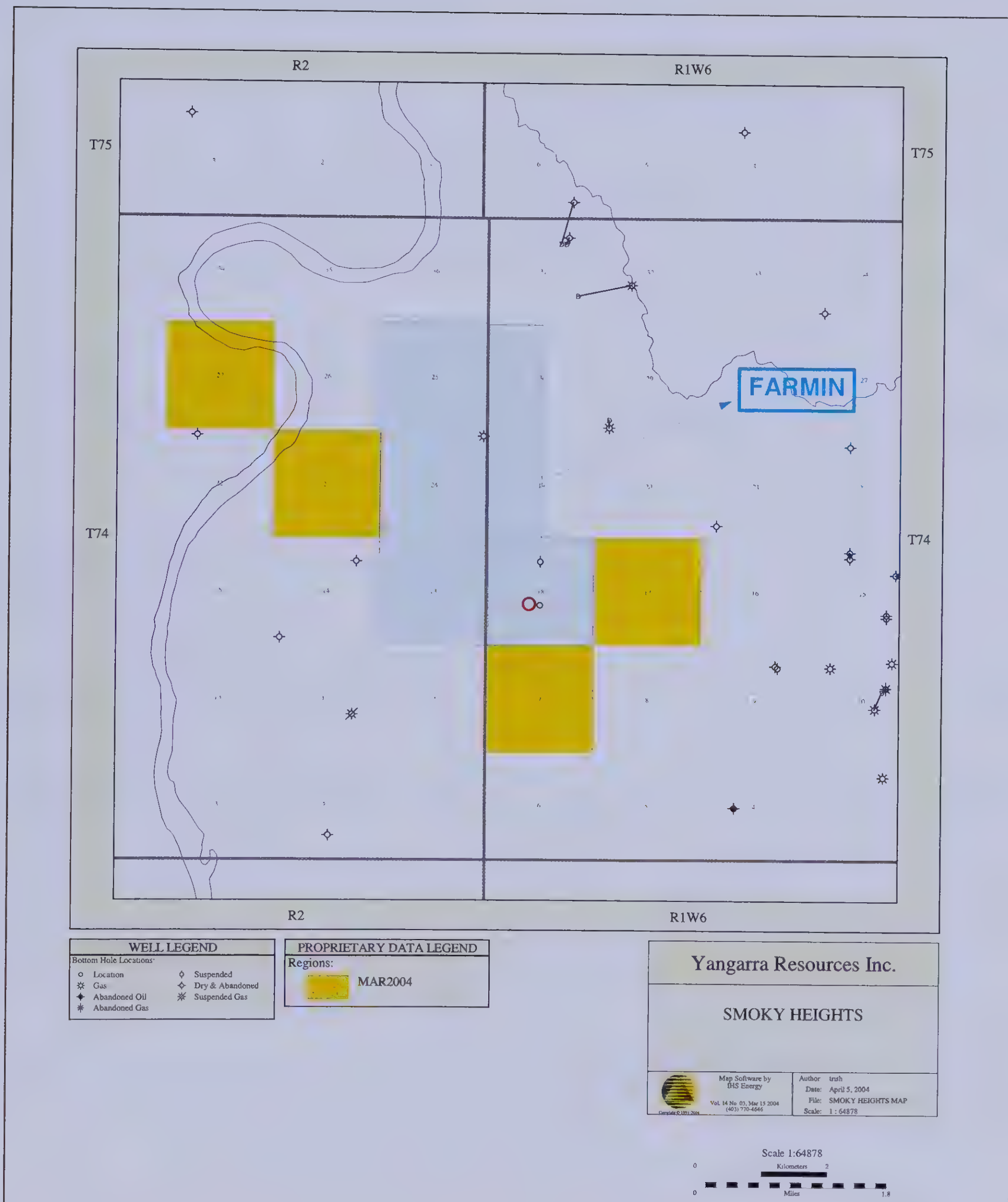
Paradise Project

Smoky Heights

Yangarra has an interest in a total of nine sections (33 1/3% working interest) overall with farm in terms on five sections.

This play is chasing the Kiskatinaw with the first well drilled in Q1/04 which was not cased but did prove up the geological and geophysical model. 3D seismic will be done with a follow-up location planned for Q3.
The Kiskatinaw in this area is potentially very prolific with rates of 5-15 million mcf day with 5-20 bcf reserves possible. Those factors make it a very high impact – low cost play.

Medicine Hat



Smoky Heights Project

For the years ended December 31, 2003 and 2002

The following information has been prepared by management and should be read in conjunction with the audited consolidated financial statements for the years ended December 31, 2003 and 2002. Petroleum and natural gas reserves and volumes are converted to a common unit of measure on a basis of six thousand cubic feet (Mcf) of gas to one barrel (Bbl) of oil.

Highlights of 2003

- The Corporation consolidated its shares four to one and changed its name from Ayrex Resources Ltd. to Yangarra Resources Inc. ("Yangarra").
- The successful completion of four financings resulted in gross proceeds of $8.9 million.
- A bank credit facility was secured to provide up to $ 2.5 million.
- A farm-in arrangement in the Medicine Hat area in southeastern Alberta and a joint venture agreement in the Ferrier area in central Alberta, firmly establish the Corporation's primary exploration and development direction.
- Capital expenditures on resource properties and facilities totaled $9.0 million in 2003 compared to $176,000 in 2002.
- Production commenced during the last 10 days of December and net sales were 140 BOE per day.
- At December 31, 2003 Sproule Engineering evaluated the Corporation' s total proved plus probable reserves to have a net present value before income taxes discounted @10% of 18.0 million. At the end of the previous year, the Corporation had zero reserve value.
- At December 31, 2003 undeveloped land was valued $2.1 million compared to $67,200 at the end of 2002.
- Net earnings in 2003 were $384,780 compared to a loss in 2002 of $834,761.
- At December 31, 2003 Yangarra was without bank debt.
- Finding and development costs at December 31, 2003 with future capital included were $12.93 per BOE proven and $8.92 per BOE proven plus probable.

Natural gas revenues

Gross revenues increased in 2003 to $52,356 from $2,152 in 2002 due to this year's success in establishing productive core areas. Production from 19 shallow gas wells in the Medicine Hat area commenced in late December 2003 and net sales were 140 BOE per day. December gas prices averaged $6.01 per thousand cubic feet ("Mcf").

Production expenses

Production expenses increased in 2003 to $37,424 from $12,326 due primarily to start-up costs associated with bringing 19 new wells on-stream. Since 2003 only saw partial production at the year-end, it is still premature to calculate and analyze any meaningful per barrel of equivalent data.

General and administrative costs

General and administrative costs, after operating recoveries, increased 133 % this year to $167,367 from $71,820 last year. Until July 1, 2003 Yangarra (formerly Ayrex Resources Ltd.) was a small operation searching for exploration and development opportunities, in which the Corporation would not be the operator. Under this regime, costs were minimal and consulting services were limited to part-time administrators and "office sharing" satisfied physical location.

Commencing July 1, 2003 the commitment to grow Yangarra included leasing office space with the necessary equipment, to accommodate up to ten oil and gas specialists to achieve the Corporation's goals. Rent expense in 2003 increased to $43,000 compared to $2,150 in 2002. Consulting fees increased to $85,050 compared to $24,250 in the prior year. Legal and accounting fees totaled $52,750 due to increased corporate activities including new financings and joint venture agreements. Costs associated with investor relations, engineering and business valuations were also higher as each professional organization diligently complied with changing securities rules and regulations.

Cost recoveries related to capital project administration were $91,400 compared to none last year. No general and administrative cost indirectly associated with exploration or development was capitalized in either 2003 or 2002.

Depletion, depreciation and site restoration

Depletion and depreciation expense totaled $30,400 in 2003 compared to $719,824 in 2002. A comparison of this year's depletion rate of $12.98 per BOE to that of last year will be significantly skewed since last year's depletion expense included a ceiling test impairment of $707,800.

Taxes

A future tax recovery of $1,154,516 was recorded in 2003 earnings (2002 - $178,872). The income tax recovery differs from the amount that would be expected by applying the current tax rates for the following reasons:

		2003		2002
Earnings (loss) before taxes	$	(769,736)	$	(1,013,633)
Expected tax expense at 40.79% (2002 – 42.42%)		(313,975)		(429,983)
Tax effect of expenses not deductible for tax purposes:				
Resource loss		20,632		8,959
Stock based compensation		239,029		-
Valuation allowance from the prior year		(1,127,253)		242,152
Other		27,051		-
Future income tax recovery	$	(1,154,516)	$	(178,972)

Net earnings (loss)

In 2003, the loss before taxes was $769,700, a 24 percent improvement over the $1.0 million loss in 2002. The 2002 net loss before taxes included a $707,800 impairment from the ceiling test.

This year's results reflect net earnings of $ 384,780 that include a future income tax recovery of $1.1 million compared to a net loss for 2002 of $834,761 that included a future income tax recovery of $179,000.

Capital

Property and equipment balance at December 31,2002	$	175,956
Additions	$	8,992,385
Depletion and depreciation	$	(29,509)
Property and equipment balance at December 31, 2003	$	9,138,832

Exploration and development expenditures		2003		2002
Land	$	2,436,810	$	176,419
Geological and geophysical		560,135		14,514
Drilling and completion		4,078,600		274,244
Plant and facilities		1,872,496		32,855
Total Exploration and Development	$	8,948,041	$	498,032

Expenditures by Area

	Land	Geological & Geophysical	Drilling & Completion	Plant & Facilities	Other	Total
Medicine Hat	1,122,338	20,793	3,005,747	1,817,809		5,966,687
Ferrier	764,793		978,200			1,742,993
Paradise	678,222	69,270	29,851			777,343
Smoky Heights	56,320		361			56,681
Other	41,122	229,528	29,899		148,132	448,681
Total	2,662,795	319,591	4,044,058	1,817,809	148,132	8,992,385

Drilling Activity

	Drilling & Producing		Abandoned or suspended		Work in Progress	
	Gross	Net	Gross	Net	Gross	Net
Medicine Hat	19.0	9.5			2.0	1.0
Ferrier					2.0	1.0
Paradise					1.0	0.5
Smoky Heights						
Other						
Total	19.0	9.5	0	0	5.0	2.5

Liquidity and capital resources

At December 31, 2003, Yangarra's market vale of common shares was $21,858,600 based on the December 31 price of $1.20 per share.

At December 31, 2003 the Corporation's working capital deficiency was $506,400, up 133 percent from the $217,600 deficit in 2002. At year-end, there was $2.5 million of unused bank line still available. Details of this credit facility are explained in note 7 of the financial statements.

Reserves

Yangarra retained the independent engineering firm of Sproule Associates Limited to evaluate the Corporation's reserve properties at January1, 2004. The Audit Committee has recommended acceptance of the Sproule reserve estimates for the purposes of the Annual Report.

Reserves reconciliation	Crude oil and liquids (Mstb)			Natural gas (Bcf)			Barrel equivalent (6:1)(MBbl)		
	Proven	Probable	Total	Proven	Probable	Total	Proven	Probable	Total
Total at Jan 1, 2003	0	0	0	0	0	0	0	0	0
Development	85.4	35.6	121.0	5.5	4.4	9.9	1,000	770	1,770
Production	0	0	0	(0.01)	-	(0.01)	1.7	-	1.7
Total at Dec 31,2003	85.4	35.6	121.0	5.5	4.4	9.9	998.3	770	1768.3

Sproule used the following pricing assumptions in the escalated reserves pricing case.

Pricing assumptions	WTI ($US/Bbl)	Edmonton Reference Price ($Cdn/Bbl)	AECO-C Spot Price ($Cdn/MMBTU)
2004	29.63	37.99	6.04
2005	26.80	34.24	5.36
2006	25.76	32.87	4.80
2007	26.14	33.37	4.91

Summary of reserve value – escalated prices

Reserves category	NGL MSTB		Sales Gas MMcf		BOE MSTB		Net Present Value		
	Gross	Net	Gross	Net	Gross	Net	Undisc	10%	15%
Proved producing	0	0	1,133	1,014	188.9	169.0	3,355	2,643	2,404
Proved undeveloped	128.3	85.4	5,469	4,463	1039.8	829.3	12,928	7,431	5,850
Total Proved	128.3	85.4	6,602	5,477	1228.7	998.3	16,283	10,074	8,254
Probable	53.2	35.6	5,197	4,428			14,424	7,995	6,348
Total proved plus probable	181.5	121.0	11,799	9,905	1228.7	998.3	30,709	18,068	14,602

Gross reserves are the total of the Company's working and/or royalty interest share before deduction of royalties owned by others.

Net reserves are the total of the Company's working and/or royalty interest share after deducting the amounts attributable to royalties by others.

Net asset value ($0000, except per share data)	2003	2002
Proved plus probable reserves at 10%	18,068	0
Value of undeveloped land	2,100	67
Working capital (deficiency)	(506)	(218)
Net asset value	19,662	(151)
Common shares outstanding (thousands)	18,216	3,337
Net asset value per share	1.08	(0.05)

Business Risks

Yangarra is engaged in the exploration, development and production of crude oil and natural gas. The oil and gas business is inherently risky and there is no assurance that hydrocarbon reserves will be discovered and economically produced. Operational risks include competition, reservoir performance uncertainties, environmental factors, and regulatory, environment and safety concerns. Financial risks associated with the petroleum industry include fluctuations in commodity prices, interest rates, currency exchange rates and the cost of goods and services. Yangarra employs highly qualified people, uses sound operating and business practices, and evaluates all potential and existing wells using the latest applicable technology. Yangarra complies with government regulations and has in place an up-to-date emergency response plan. Environment and safety policies and standards are adhered to. Liabilities for future abandonment and restoration costs are assessed and provided for annually. Yangarra maintains property and liability insurance coverage, as well as directors and officers liability insurance. The coverage provides a reasonable amount of protection from risk of loss; however, not all risks are foreseeable or insurable.

Outlook

Subsequent to the year-end, Yangarra has drilled five successful gas wells in the Ferrier area of central Alberta. These wells have a combined 10.9 million cubic feet of gas behind pipe (net 3.1 million cubic feet) with 45 barrels/million feet of associated liquids (net 139 barrels). A gas plant capable of 10.0 million cubic feet a day (expandable to 15.0 million cubic feet/day) is under construction and will be onstream in April, 2004. Seven additional wells are planned for 2004 and two oil plays are being pursued on the property.

In Medicine Hat, optimization is underway with a water handling and injection system scheduled for late spring. This system will cut operating costs significantly as this project has high water rates. Gas flow optimization is ongoing and management is encouraged by the results to date. A plant expansion and 30 additional wells are planned for the fourth quarter.

Exploration is continuing at Paradise and Smokey Heights. Management will decide on the future of these projects when more wells have been drilled. Results to date are encouraging.

Yangarra's balance sheet is strong with a $3.6 million dollar financing announced in March, 2004 with projected cash flow and debt capacity large enough to support a forecast $14.7 million dollar capital budget for 2004.

Drilling with coil tubing rig @ Medicine Hat 14-29-9-6W4

Management's Report

Management has responsibility for preparing the accompanying consolidated financial statements. This responsibility includes selecting appropriate accounting principles and making objective judgments and estimates in accordance with Canadian generally accepted accounting principles.

In discharging its responsibilities for the integrity and fairness of the financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets safeguarded and proper records maintained.

The Board of Directors has appointed an Audit Committee, consisting of three Directors two of whom are neither employees nor officers of the Company. The Audit Committee is appointed by the Board to review the consolidated financial statements in detail with management and to report to the Board prior to their approval of the consolidated financial statements for publication.

External auditors are appointed by the shareholders to audit the consolidated financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically with, the Audit Committee, the Board and management.

James G. Evaskevich

Gordon A. Bowerman

Auditor's Report

We have audited the consolidated balance sheets of Yangarra Resources Inc. as at December 31, 2003 and 2002 and the consolidated statements of net earnings (loss) and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

"Signed: Meyers Norris Penny LLP"
Chartered Accountants
Calgary, Alberta
February 13, 2004

Balance Sheets

	2003	2002
Assets		
Current		
Cash	2,787,200	9,446
Marketable securities	252,727	
Accounts receivable	1,895,052	3,536
Deposits	59,012	13,054
	4,993,991	26,036
Investments (Note 4)	176,805	176,805
Property and equipment (Note 5)	41,074	-
Resource properties (Note 6)	9,097,758	175,956
	14,309,628	378,797
Liabilities		
Current		
Accounts payable and accruals	5,500,391	188,714
Payable to shareholders	-	55,000
	5,500,391	243,714
Future income taxes (Note 8)	1,529,553	-
Future site restoration	12,914	12,000
	7,042,858	255,714
Shareholders' Equity		
Share capital (Note 9)	11,934,348	5,761,441
Contributed surplus (Note 9)	586,000	-
Deficit	(5,253,578)	(5,638,358)
	7,266,770	123,083
	14,309,628	378,797

Approved on behalf of the Board:

James G. Evaskevich Director

Gordon A. Bowerman Director

Statement of operations

	2003	2002
Revenue		
Petroleum and natural gas sales	52,356	2,152
Royalties, net of Alberta Royalty Tax Credit	(878)	-
Interest	-	154
	51,478	2,306
Expenses		
Production	37,424	12,326
Administration	167,367	71,820
Amortization, depletion and site restoration (Note 5 and Note 6)	30,423	719,824
	235,214	803,970
Loss from operations	(183,736)	(801,664)
Other income (expense)		
Non-cash stock-based compensation	(586,000)	-
Recovery on mining property	-	12,500
Write-down of investments to market value	-	(224,469)
	(586,000)	(211,969)
Loss before income taxes	(769,736)	(1,013,633)
Future income tax recovery (Note 8)	1,154,516	178,872
Net earnings (loss)	384,780	(834,761)
Deficit, beginning of year, as previously stated	(5,638,358)	(4,888,837)
Prior period adjustment (Note 14)	-	85,240
Deficit, beginning of year, as restated	(5,638,358)	(4,803,597)
Deficit, end of year	(5,253,578)	(5,638,358)
Earnings (loss) per share (Note 13)		
Basic	0.05	(0.27)
Diluted	0.04	-

Statement of cash flows

	2003	2002
Cash provided by (used for) the following activities		
Operating		
Net earnings (loss)	384,780	(834,761)
Amortization, depletion and site restoration	30,423	719,824
Loss on write-down of investments to market value	-	224,469
Loans payable forgiven	-	-
Non-cash stock-based compensation	586,000	-
Future income tax recovery	(1,154,516)	(178,872)
	(153,313)	(69,340)
Changes in non-cash working capital accounts		
Accounts receivable	(1,891,516)	(3,431)
Deposits	(45,958)	(13,054)
Accounts payable and accruals	10,016	(14,953)
	(2,080,771)	(100,778)
Financing		
Shares issued, net of share issuance costs	8,646,976	15,000
Repayment of shareholders' loans	(55,000)	-
Loans from shareholders	-	25,000
	8,591,976	40,000
Investing		
Purchase of marketable securities	(252,727)	-
Purchase of property and equipment (Note 5)	(44,344)	-
Purchase of and expenditures on resource properties (Note 6)	(3,436,380)	(391,161)
Mining property receipt	-	12,500
	(3,733,451)	(378,661)
Increase (decrease) in cash	2,777,754	(439,439)
Cash, beginning of year	9,446	448,885
Cash, end of year	2,787,200	9,446
Supplemental cash flow information		
Interest paid	6,529	258

1. Incorporation and nature of operations

The Company was incorporated under the laws of the Province of Alberta on January 22, 1985 as Ayrex Resources Ltd., but changed its name to Yangarra Resources Inc. ("the Company") and started trading on the TSX Venture Exchange under that name on July 21, 2003. The Company is a natural resource company and is involved in both oil and gas exploration and development and mineral exploration.

2. Accounting policies

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles, and include the following significant accounting policies:

Going concern

These consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the payment of liabilities in the ordinary course of business. Should the Company be unable to continue as a going concern, it may be unable to realize the carrying value of its assets and to meet its liabilities as they become due.

The Company's ability to continue as a going concern is dependent upon its ability to attain profitable operations and generate funds there from and to continue to obtain capital financing from investors sufficient to meet current and future obligations.

Basis of Consolidation

The Company has consolidated the assets, liabilities, revenues and expenses of the Company and its inactive subsidiary, Mount Julian Resources Ltd., after the elimination of inter-company transactions and balances.

Marketable securities

Marketable securities are valued at the lower of cost and market. At December 31, 2003, cost approximates market value.

Investments

Investments are stated at the lower of cost less any provisions for other than temporary impairment. They have been classified as long-term assets in concurrence with the nature of the investment.

Property and equipment

Property and equipment are initially recorded at cost. Amortization is provided using methods and rates intended to amortize the cost of assets over their estimated useful lives.

	Method	Rate
Computer equipment	Declining balance	30%
Leasehold improvements	Straight line	3 years
Office equipment	Declining balance	20%

In the year of acquisition, amortization is taken at one-half of the above rates.

Resource properties

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method all costs related to the acquisition of, exploration for, and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses and costs of drilling both productive and non-productive wells and overhead costs directly related to exploration and development activities. Proceeds from the sale of properties and equipment are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion and amortization.

Ceiling test

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of resource properties and production equipment, net of recorded future income taxes and the accumulated provision for site restoration and abandonment costs, is compared annually to an estimate of future net cash flow from the production of gross proven reserves. Net cash flow is estimated using year-end prices, less estimated future general and administrative expenses, financing costs, estimated future site restoration and abandonment costs and income taxes. Should this comparison indicate an excess carrying value, the excess is charged against operations as additional depletion and amortization.

Depletion and amortization

Depletion of resource properties and amortization of production equipment, net of estimated salvage or residual value, is provided using the unit-of-production method based upon estimated proven resource reserves before royalties, as determined by independent engineers. For depletion and amortization purposes, relative volumes of petroleum and natural gas production and reserves are converted at the energy equivalent conversion rate of six thousand cubic feet of natural gas to one barrel of crude oil.

Future site restoration and abandonment costs

The estimated cost of site restoration is based on the current cost and the anticipated method and extent of site restoration in accordance with existing legislation and industry practice. Estimated future site restoration and abandonment costs are accrued on a unit-of-production method based on gross proven reserves. The provision is recorded on the statement of earnings. Site restoration and abandonment expenditures are charged to the accumulated provision as incurred.

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of revenues and expenses during the reporting period. Accounts receivable are stated after evaluation as to their collectibility and an appropriate allowance for doubtful accounts is provided where considered necessary. The amounts recorded for depletion and amortization of resource properties, the provision for site restoration and abandonment and the ceiling test are based on estimates of gross proven reserves, production rates, oil and gas prices, future costs and other relevant assumptions. These assumptions are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

Joint venture activity

Substantially all of the Company's oil and gas exploration, development and production activities are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

Income taxes

The Company follows the asset and liability method to account for income taxes. The asset and liability method requires that income taxes reflect the future tax consequences of temporary differences between the carrying amounts of assets and liabilities and their tax basis. Future income tax assets and liabilities are determined for each temporary difference based on the tax rates that are expected to be in effect when the underlying items of income and expenses are expected to be realized. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

Flow-through shares

Share capital includes flow-through shares issued pursuant to certain provisions of the Income Tax Act (Canada) ("the Act"). Under the Act, where the proceeds are used for eligible expenditures, the related income tax deductions may be renounced to subscribers.

Share capital is reduced by an amount equal to the estimated future income taxes payable by the Company as a result of the renunciations and the estimated future income taxes payable are recorded as an increase to the future income tax liability.

Stock based compensation

Effective January 1, 2002 the Company adopted CICA Handbook 3870 "Stock-based Compensation and Other Stock-based Payments", which establishes standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services to employees and non-employees. The standard sets out a fair-value based method of accounting that is required for certain, but not all, stock-based transactions.

The Company records compensation expense in the consolidated financial statements for stock options granted to employees and directors using the fair value method. Fair values are determined using the Black-Scholes option pricing model. Compensation costs are recognized over the vesting period (Note 3).

Earnings per share

Basic earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated based on the treasury stock method which assumes that any proceeds obtained on the exercise of options would be used to purchase common shares at the average price during the period.

3. Change in accounting policy

Stock based compensation

The Company has early-adopted the Canadian accounting standard as outlined in CICA Handbook 3870 "Stock-based Compensation and Other Stock-based Payments". As allowed by the section, this policy has been adopted prospectively, with no restatement of prior years' balances. The adoption of the new accounting standard for stock-based compensation resulted in the Company recognizing an expense of $586,000 in 2003.

4. Investments

The Company owns 2,525,786 (2002 – 2,525,786) shares of Tandem Resources Ltd. As at December 31, 2003 the carrying value of these shares remained at $176,805, and its market value was $196,664 (2002 – $176,805), which is based on its last trading price as indicated on the TSX Venture Exchange. The company's shares are currently halted from trading.

5. Property and equipment

	Cost	Accumulated Amortization	2003 Net Book Value	2002 Net Book Value
Computer equipment	15,750	1,648	14,102	-
Leasehold improvements	19,771	1,181	18,590	-
Office equipment	8,823	441	8,382	-
	44,344	3,270	41,074	-

6. Resource properties

	Cost	Accumulated Depletion	2003 Net Book Value	2002 Net Book Value
Petroleum and natural gas properties	9,723,066	734,064	8,989,002	67,200
Mineral properties	108,756	-	108,756	108,756
	9,831,822	734,064	9,097,758	175,956

Based on the results of exploration activities and the year-end ceiling test, management has provided for no write down (2002-$707,824) of petroleum and natural gas properties.

During the year, resource property expenditures and acquisitions totaled $8,948,041 (2002 - $498,032) of which $5,301,661 (2002 -$106,871) were accrued in accounts payable and accruals, $210,000 (2002 – $nil) were acquired through issue of common shares and $3,436,380 (2002 - $391,161) were acquired with cash.

During the year, no administration expenses have been capitalized.

On July 1, 2003, the Company entered into an agreement with Entrada Energy Inc. ("Entrada"), a private company, related through common ownership and directors, to earn a 50% working interest in Entrada's resource properties. As consideration, the Company was required to spend approximately $4,600,000 on Entrada's property. This amount was to retired Entrada's working capital deficiency of approximately $1,000,000 and the balance was to be spent on the development of the property.

During the prior year, the Company and its joint venture partner entered into a Letter Agreement with a third party to option a 51% interest in the Frond Lake Property whereby the third party will incur exploration expenditures aggregating $750,000 over two years, of which 50% will be spent in the first year. During fiscal 2002, the Company received $12,500 relating to this agreement, which has been recorded as a recovery on mineral properties in the statement of earnings

The Company also holds a 100% interest in various claims in Quebec. The Company expects that these claims will expire during the next fiscal year. The required expenditures during fiscal 2002 were $25,000.

7. Credit arrangements

The Company has an operating line of credit available with the National Bank of Canada. The maximum available credit is $500,000, which bears interest at prime plus 0.75% and requires interest payments only. At December 31, 2003, this operating line of credit has no balance. The Company also has a non-revolving development demand loan with the National Bank of Canada. The maximum available credit is $2,000,000, which bears interest at prime plus 1.00%. At December 31, 2003, the demand loan has no balance.

These credit facilities are secured by a registered general assignment of book debts and a first fixed and floating charge debenture in the minimum face amount of $10,000,000.

Subsequent to the year-end, the line of credit was increased to $2,500,000 while the non-revolving development demand loan was cancelled. The other terms and conditions of the line of credit were unchanged.

The Company has a letter of credit with the National Bank of Canada in the amount of $252,727. This letter of credit is secured by a $252,727 term investment bearing interest at 0.875% maturing January 28, 2004. The letter of credit represents irrevocable assurances that the National Bank of Canada will pay if the Company cannot meet its obligations to the Alberta Energy and Utilities Board (EUB) for security deposits. As at December 31, 2003, no security deposits have been requested.

8. Income taxes

The components of the net future income taxes liability are as follows:

	2003	2002
Future income tax liabilities		
Property and equipment	(67,183)	-
Resource properties	(2,090,656)	-
Future income tax assets		
Property and equipment	-	9,146
Resource properties	-	700,504
Share issue costs	110,385	-
Site restoration	4,845	5,090
Provincial royalties	2,583	9,131
Non-capital losses	510,473	403,382
Future income tax asset (liability)	(1,529,553)	1,127,253
Valuation allowance	-	(1,127,253)
Future income tax liability	(1,529,553)	-

The income tax recovery differs from the amount that would be expected by applying the current tax rates for the following reasons:

	2003	2002
Earnings (loss) before taxes	(769,736)	(1,013,633)
Expected tax expense at 40.79% (2002 – 42.42%)	(313,975)	(429,983)
Tax effect of expenses not deductible for tax purposes:		
Resource loss	20,632	8,959
Stock based compensation	239,029	-
Valuation allowance from the prior year	(1,127,253)	242,152
Other	27,051	-
Future income tax recovery	(1,154,516)	(178,87)

At December 31, 2003, the Company has the following estimated tax pools available for deduction against future taxable income:

	2003	2002
Canadian oil and gas property expense	3,855,000	1,191,000
Canadian development expense	1,259,000	317,000
Canadian exploration expense	89,000	89,000
Foreign exploration and development expense	228,000	228,000
Undepreciated capital cost	2,034,000	28,000
Share issuance costs	294,000	-
Non-capital losses	1,360,000	950,000

In 2002, a future income tax asset of $178,872 relating to the non-capital losses was recognized sufficient to offset the future tax liability recognized on the flow-through expenditures.

The non-capital losses will expire as follows:

2004	137,000
2005	356,000
2006	186,000
2007	120,000
2008	86,000
2009	64,000
2010	411,000

9. Share capital

Authorized
Unlimited number of Class A voting common shares, without nominal or par value
Unlimited number of Class B non-voting common shares, without nominal or par value
Unlimited number of Class C non-voting common shares, without nominal or par value
Unlimited number of Class D non-voting, non-cumulative redeemable preferred shares

	Number	Value
Issued Common shares		
Balance ending, December 31, 2001	11,606,999	5,505,313
Flow-through shares issued	1,740,000	435,000
Effect of future income taxes on flow-through expenditures	-	(178,872)
Balance ending, December 31, 2002	13,346,999	5,761,441
Share consolidation 4 to 1 (i)	(10,010,249)	-
Private placement (ii)	3,300,000	660,000
Private placement (iii)	2,500,000	1,050,000
Finder's fees (iii)	500,000	210,000
Flow-through shares issued (iv)	5,000,000	3,750,000
Flow-through shares issued (v)	3,500,000	3,500,000
Effect of future income taxes on flow-through expenditures (iv) (v)	-	(2,827,500)
Options exercised	78,750	54,750
Share issuance costs	-	(367,774)
Effect of future income taxes on share issuance costs	-	143,431
Balance ending, December 31, 2003	18,215,500	11,934,348

(i) On July 18, 2003, the TSX Venture Exchange Inc. approved the consolidation of the outstanding common shares of the Company, converting every four common shares into one common share, reducing the Company's issued and outstanding shares from 13,346,999 to 3,336,750. The Company's 2002 earnings per share has been restated to reflect the impact of this consolidation as if it had occurred at the beginning of 2002.

(ii) On July 31, 2003, the Company completed a non-brokered private placement of 3,300,000 units at a price of $0.20 per unit, for gross proceeds of $660,000. Each unit consisted of one common share of the Company and one share purchase warrant. Each warrant entitles the holder to purchase one common share, at any time, for a period of two years at a price of $0.30 per share.

(iii) On September 12, 2003, the Company completed a non-brokered private placement of 2,500,000 common shares at a price of $0.42 per common share, for gross proceeds of $1,050,000. Also on this date, the Company paid a finder's fee, through the issuance of 500,000 common shares at a price of $0.42 per share for a value of $210,000, to a director in consideration for securing a farmin agreement.

(iv) On October 10, 2003, the Company completed a non-brokered private placement of 5,000,000 common shares issued on a "flow-through" basis at a price of $0.75 per common share, for gross proceeds of $3,750,000. All of the qualifying expenditures relating to this issue have been renounced to the shareholders with all expenditures being incurred.

(v) On November 20, 2003, the Company completed a brokered private placement of 3,500,000 common shares issued on a "flow-through" basis at a price of $1.00 per share, for gross proceeds of $3,500,000. All of the qualifying expenditures relating to this issue have been renounced to the shareholders with all expenditures being incurred.

Stock options

The Company has a stock option plan under which the Board of Directors may grant options to directors, officers, other employees and key consultants. The purpose of the plan is to advance the interests of the Company by encouraging these individuals to acquire shares in the Company and thereby remain associated with, and seek to maximize the value of, the Company. Under the plan, the number of shares reserved for issuance pursuant to the exercise of all options under the plan may not exceed 10% of the issued and outstanding common shares on a non-diluted basis at any time. The options vest immediately and expire not more than five years from the date of grant, or earlier if the individual ceases to be associated with the Company.

	Number of Options	Price Range	Weighted Average Price	Expiry Date
Balance ending, December 31, 2001	1,000,000	0.20	0.20	2005
Granted	1,075,000	0.15	0.15	2007
Cancelled	(650,000)	0.20	0.20	2005
Expired	(100,000)	0.20	0.20	-
Balance ending, December 31, 2002	1,325,000	0.15 - 0.20	0.16	2005-2007
Share consolidation 4 to 1	(993,750)	0.15 - 0.20	0.16	2005-2007
Granted	1,480,000	0.20 - 1.00	0.63	2007
Exercised	(78,750)	0.15 – 1.00	0.70	2005-2007
Balance ending, December 31, 2003	1,732,500	0.15 – 1.00	0.54	2005-2007

The Company uses the Black-Scholes option pricing model to estimate the fair value at the date of grant for options granted. During 2003, 1,480,000 options with an estimated fair value of $586,000 and a weighted average of $0.40 were granted and have been expensed as stock-based compensation with a corresponding credit to contributed surplus. The estimated fair value was determined using the following assumptions:

Risk free interest rate	4.75%
Expected volatility range	75% to 80%
Expected life	4 to 5 years

Option pricing models require the input of highly subjective assumptions including the expected price volatility. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options.

Warrants

In connection with financing activities, the Company has the following warrants outstanding:

	Number of Warrants	Price Range ($)	Weighted Average Price ($)	Expiry Date
Balance ending, December 31, 2002	-	-	-	-
Issued	3,300,000	0.30	0.30	2005
Balance ending, December 31, 2003	3,300,000	0.30	0.30	2005

10. Commitments

The Company has entered into operating lease agreements for equipment and building with estimated minimum annual payments as follows:

2004	261,837
2005	211,786
2006	46,939

One half of the monthly equipment lease payments will be reimbursed by a company controlled by certain of the Company's directors and officers.

11. Related party transactions

The Company has entered into operating lease agreements for equipment and building with estimated minimum annual payments as follows:

	2003	2002
Administration and consulting expenses	148,479	1,000
Production expenses	-	7,141
Capital expenditures	1,876,878	498,031

During the year, an aggregate of $50,114 was paid to Burstall Winger LLP for legal fees and disbursements. A director of the Company is a partner of Burstall Winger LLP.

Included in accounts payable and accruals is $260,665 (2002 - $159,985), and in accounts receivable is $1,384,249 (2002 - $nil), relating to the above transactions.

These transactions were in the normal course of operations and were measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

12. Financial instruments

The Company, as part of its operations, carries a number of financial instruments. It is management's opinion that the Company is not exposed to significant interest, credit or currency risk arising from these financial instruments.

Fair value

The fair value of the Company's accounts receivable, marketable securities, accounts payable and accruals, and payable to shareholders approximate their carrying value due to the short-term nature of these instruments.

13. Per share amounts

Basic loss per share is calculated using the weighted average number of shares outstanding for the year. For purposes of the calculations, the weighted average number of shares outstanding was 7,539,387 (2002 – pre-consolidation: 12,479,382; post-consolidation: 3,119,846).

The number of shares added to the weighted average number of common shares outstanding for the dilutive effect of options utilizing the treasury stock method was 2,329,412 (2002 – nil).

14. Prior period adjustment

During 2002, the Company determined that the 2001 flow-through share issue was not tax effected. The Company also determined that sufficient future income tax assets exist to offset the liability arising from that flow-through share issue. As a result, 2001 after tax earnings were increased, and deficit decreased, by $85,240.

15. Comparative figures

Certain of the comparative figures have been reclassified to conform to the current year's presentation.

Corporate information

Directors & Officers

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Jake Pronk
COO & Chairman of the Board

Robert Weir
VP Engineering & Director

John Aihoshi
VP Finance & CFO

Gordon Bowerman
Director

Douglas Stuve
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